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Brazil: Slow Going On Privatization of State-Owned Firms

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Summary

A key factor behind Brazil's financial difficulties and inflationary economy is the huge public sector deficit. In attempting to implement economic reforms to restrain that deficit, Brasilia over the past decade has initiated several programs to privatize indebted, moneylosing state-owned enterprises. These efforts, however, have been ineffective and today, despite heavy subsidies, state-owned firms remain unprofitable and their foreign debts constitute nearly two-thirds of Brazil's medium and long-term overseas debt, up from just over half in 1980. We see almost no chance that the lameduck Sarney Administration will make headway in divesting white elephants: too many powerful interest groups oppose privatization and, with presidential elections approaching, the need to secure political support will lead to more, not less federal spending. Failure to deal with the bloated state-owned firms will continue to hamstring economic growth by widening the public sector deficit and reducing credit available to the private sector. Failure to rein in the parastatals is another strong indicator that Brazil will remain

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unable to make fiscal reforms desired by the United States and other major creditors, while the red tape and import restrictions that go with the state firms will continue to harm the interests of Brazil's trading partners. []

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Introduction

As Brazil's economy grew to become one of the largest in the developing world, government-owned enterprises played a key part by buffering the country against international economic crises, by spurring economic growth, and by providing a framework for modernization. Despite these earlier economic benefits, however, the parastatal sector has more recently become an unmanageable and costly drag on the already struggling economy, rather than a source of growth. Officials, businessmen, and academics now increasingly focus on the role of state enterprises as they debate whether to alter Brazil's overall development strategy. Change has proven exceedingly difficult, however, even though the high price of maintaining the state entities is clear, because the attitudes that led to the growth of parastatals are deeply ingrained and the companies themselves are well entrenched.

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State Economic Intervention: A Tradition

The factors behind pervasive, state intervention in the economy have varied over time, from a desire to defend against international crises or protect domestic industries to a means of achieving rapid industrialization. The devastating impact of collapsing coffee sales--Brazil's single major export--during the global depression of the 1930s solidified the government's determination to shield against damaging external economic cycles. No state enterprises were created at the time, but the powers of the state to direct the economy were strengthened markedly. For example, the Vargas regime (1930-45), in its first foray into the productive sector, determined output and prices for the coffee industry and controlled pricing on basic services such as water and electricity. []

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The military joined with nationalist politicians during the 1940s to urge the development of state-owned basic industries, playing on government fears that war-induced market dislocations could, like the depression, wreak havoc in Brazil's economy. In the postwar years, ambitious modernization goals and renewed economic nationalism dominated the thinking of Brazilian

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planners. Government strategists recommended an elaborate development plan that was beyond the capabilities of private enterprise, and concluded that its success depended on government initiatives. As a first step, they founded the National Bank for Economic and Social Development (BNDES) to provide long term credits to finance large-scale modernization projects, heavy industry, and the opening of new agricultural areas. The government then created or enhanced what are now some of the largest state entities and the core of the modern public sector in Brazil, such as the state oil monopoly, Petrobras. [REDACTED]

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The paternalistic view that government was responsible for providing a safety net for foundering businesses, as well as for ensuring a wide array of social services, also played a role in the public sector's expansion throughout these years. This interventionist trend accelerated in the 1950s, when BNDES, which originally allocated most of its funds to infrastructure projects, increasingly encroached on private enterprise by financing the sale of capital goods and the expansion of medium and small businesses. By taking over bankrupt private firms and transforming them into state enterprises, the government managed to absorb large numbers of urban workers who otherwise would have been unemployed. Such firms also benefitted private businesses; government controlled prices on steel from the state-run foundries, for example, subsidized the steel consuming manufacturing sector. [REDACTED]

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The Military Years: Heyday for State-Owned Enterprises

When the military took power in 1964, the state had already established the nucleus of a modern public enterprise sector. The military not only shared previous governments' aspirations of rapid economic growth and modernization, but, with unchallenged political power, was well positioned to implement the ambitious plans. Brasilia viewed the parastatals as an established, relatively disciplined mechanism on which to build. As a result, leadership of the state corporations increasingly came from the senior ranks of the military government: General Ernesto Geisel, eventually President of Brazil, headed Petrobras; retired army General Costa Cavalcanti directed Eletrobras and the Itaipu hydroelectric project; and former military officials have also directed state telecommunications and steel holding companies. Hence, the state firms grew not only economically, but clearly gained increasing political power. [REDACTED]

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The 1970s saw dizzying growth in the state enterprises. By late in the decade the federal government owned all telecommunications, electricity and gas utilities, railways, and petroleum and coal production, as well as two thirds of steel production and large pieces of many other industries; this placed Brazil among the most statist non-Communist countries. In 1979,

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these firms accounted for 60 percent of domestic investment, 40 percent of non-oil imports, and 30 percent of GDP. []

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Although the parastatals had helped Brazil develop economically, their rapid expansion produced disturbing new trends. State-run firms became so numerous and powerful that the central government could no longer effectively regulate them. They became increasingly inefficient because of bloated payrolls--more than one million employees by 1985. These workers enjoyed many costly benefits, such as early retirement programs, health facilities, and employee discount stores. In addition, the growing costs of raw materials as well as rising corruption greatly increased state enterprise expenditures. Finally, parastatals had expanded into new, often unrelated fields, making their activities all the more difficult to manage and regulate. For instance, operations by the national mining company at one point included mining bauxite and manganese, producing pulp and paper, reforestation, and engineering consulting and planning services. []

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In our view, it was during these years that the burdensome costs of parastatals came to outweigh their benefits. The military's decision to borrow heavily, at home and abroad, to finance state-sector growth drove up interest rates and set Brazil up for a severe recession. The parastatals' expenditures and chronic arrears to domestic suppliers and contractors were a drain on the national treasury and a major cause of the excess demand that triggered rapid inflation and balance of payments problems beginning in the early 1980s. The state firms' preferential access to credit crowded out private sector companies, which badly needed capital for expansion. Finally, heavy foreign borrowing by state enterprises also contributed substantially to Brazil's foreign debt: from 1978 to 1980, their share of total medium and long-term foreign debt rose from 45 percent to over 50 percent. When state firms were unable to pay these debts, the federal treasury again was obliged to cover for them. []

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Recognizing these mounting costs, the administration of President Figueiredo, the last military president (1979-85), made a tentative effort to reduce the federal government's role in the economy. He created a special government office charged with allocating budgets for the parastatals, limiting their imports, and setting prices for their goods and services. One of its first tasks--to establish a definitive list of state-run entities--unearthed 560 such organizations of all sizes and types. Brasilia established another agency to select public firms for sale or liquidation. []

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But the state enterprises, by now fiefdoms of the ruling elite, fought off attempts to trim them back. Parastatal administrators managed to avoid giving detailed financial data on their operations to the central government. This thwarted Brasilia's effort to control the companies' imports, police their

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price increases, or even determine whether state firm investment projects fit with Brasilia's macroeconomic policy planning. In addition, public sector workers staged protests in the early 1980s that forced the government to abandon an effort to reduce workers' benefits. [REDACTED]

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The US Embassy reported that by the time military rule ended in 1985, only 89 state firms had been sold, a handful were dissolved, and a few others were merged. All the firms affected were small, however, and their divestiture had little impact on overall spending. In addition, IMF reports show that Brasilia shifted the accounts of some 145 smaller parastatals onto the central government books, thereby blurring somewhat the portion of debt and financing attributable to parastatals as a whole. [REDACTED]

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Civilians Return: Many Plans, Few Results

With the return of civilian government, President Sarney seemed ready to build on the modest foundations for privatization set by Figueiredo. Early in Sarney's term, Brasilia claimed it was drawing up plans to sell not only the parastatals Figueiredo had earmarked for divestiture, but about 80 other firms, using the proceeds to finance social projects. Sarney's actual approach, however, was largely neutralized by both the political clout of the state firms and the still strong custom of government involvement in state entities involved in security or strategic areas--such as communications, petroleum, and transport. [REDACTED]

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Preoccupied by other raging economic and political storms in the period since 1985, Sarney has given only occasional attention to the issue and taken only tentative action. Some non-strategic firms, such as smaller steel mills, as well as private sector firms acquired by the government following bankruptcies, were still tagged for privatization. Purportedly to facilitate the divestitures, Sarney in late 1986 gave responsibility for some targeted firms to a new federal board. When the board's director quit in protest over the lack of progress, Sarney created yet another new agency in March 1988, the Federal Privatization Council, which has done little to date. [REDACTED]

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Brasilia's inability to act forcefully has allowed the problem to grow even more significant. Today, federal, state, and municipal government spending combined with the activities of hundreds of state-owned enterprises accounts for over 50 percent of the nation's \$325 billion GDP. The exact number of state-owned enterprises is difficult to determine: recent press reports count between 300 and 400, depending on how they view the reclassification and merging of some federally-owned firms. The press also reports that during most of the 1980s, even with hefty subsidies, the state-owned sector posted profits only one third

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as large as those of foreign and private industries. In addition, state-owned enterprises' operating losses represent a smaller portion of GDP than in 1982 but the cost of financing their huge debts--both domestic and foreign--has burgeoned to about 14 percent of GDP in 1987--nearly triple their cost to Brazil in 1982. Moreover, their foreign debts represent nearly two thirds of Brazil's medium and long term external debts, up from just over half the total in 1980. [REDACTED]

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This poor performance and Brazil's worsening financial pinch have led in 1989 to renewed concern--and limited action--in some quarters. The national development bank--already the leader in divestiture--plans by mid-year to sell its shares in all 60 state firms in which it has holdings, according to public statements. Moreover, officials have sought ways around political and financial obstacles. For instance, the new Federal Privatization Council has tried to keep specific privatization cases secret as long as possible, to avoid opposition. In addition, the Council decided in August 1988 to allow private--including foreign-held--banks to act as intermediaries in sales of the shares of public firms. Other groups became creative in divesting themselves of white elephants: when the Sao Paulo municipal government attracted only a few bidders for its costly, publicly-owned convention center and the winning bidder failed to pay, the city administration negotiated a 50-year lease to a consortium of major business associations. None of these measures, however, have even come close to breaking the stalemate on significant privatization. [REDACTED]

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Sarney probably has closed the door to any significant progress on privatization during his last year in office by exempting the so called strategic and public service parastatals. These firms make up the bulk of the sector and account for about 90 percent of the budget allocated to public enterprises. Although several of the largest firms, such as the petroleum, telephone, and mining corporations, have generated profits in the past, electrical energy and steel production sectors accounted for about 60 percent of public companies' total debt service, according to the financial press. [REDACTED]

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In the absence of meaningful divestiture, Brasilia is trying to improve the efficiency of those public enterprises which, for reasons of national security or unattractiveness to buyers, will not be transferred to the private sector. According to press, the government's public firm monitoring board is strengthening its audit system, evaluating the economic and social value of investment projects, and giving adverse publicity to those firms that have exceeded their budgets, that is, are not in the black. Moreover, although Brasilia will not divest the largest parastatals to the private sector, it has increased the number of nonvoting shares available to the public through the stock market. In addition, Brasilia last year increased prices for goods and services such as steel and electricity in order to

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reduce the operating deficits of state firms in these sectors.

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Key Players

A broad range of power groups resists privatization for a variety of economic, social, and political reasons; these include members of Sarney's own Cabinet, the newly invigorated Congress, members of the military, emerging groups such as organized labor, and parts of the private sector. The consequent power struggles have been highly visible in several arenas, such as the recent process of drafting a new constitution, and in the long-running debate over public sector reform.

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The Administration

The absence of presidential leadership has been a critical impediment to privatization, and Sarney's Cabinet has been unable to fill the gap because it lacks a consensus on the issue of divestiture. Finance Minister Nobrega has advocated privatization as part of the effort to cut the overwhelming federal deficit. Nobrega's Cabinet allies, Planning Secretary Abreu and--until his death in 1988--Minister of Industry and Commerce Castelo Branco, have also urged cutbacks of government participation in the economy; they both ordered agencies under their control to sell several parastatals. According to press reports, late last year Abreu hoped--in vain--to force parastatals to divest subsidiaries and non-operational assets such as unrelated real estate holdings, through sharp cuts in the 1989 budgets of large state firms, including Petrobras, Eletrobras, and Telebras.

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In several other ministries, however--which oversee numerous, vast state firms--ministers use their influence to oppose divestiture. For instance, the powerful Minister of Mines and Energy Aureliano Chaves--whose portfolio commands three times as many state firms as any other ministry--resigned in December, largely over proposed wage cuts for petroleum workers and over the dismissal of two directors of state firms subordinate to him. Another player with no incentive to support privatization is Communications Minister Antonio Carlos Magalhaes, an old-line, savvy politician on whom Sarney relies for political advice. His power derives precisely from his control over extensive government funds--his portfolio includes the oversight of about 36 parastatals. Throughout his tenure, he has been quick to spend money for political purposes and probably will do so at an even faster pace as the presidential elections approach.

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Legislature

The Congress, which regained power under the new constitution promulgated in October 1988, is a key impediment to trimming the public sector. Sitting as the Constituent Assembly drafting a new constitution, legislators incorporated into the new charter measures to protect several sectors--such as mining and petroleum exploration--from foreign competition and influence. In addition, Congress may now alter budget allocations and decide whether to approve presidential decrees, which are now only provisional without legislative consent. In one of the first instances that Congress used this new power, it rejected proposals to accelerate privatization, lay off some 60,000 civil servants, and dismantle part of the bureaucracy, key parts of an economic stabilization plan Sarney proffered in January 1989. []

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The Military

As the key authors of state involvement in the economy and founders of most modern parastatals, military officials retain major influence on these issues. Both retired military officers heading parastatals and active duty officers have pressed Brasilia to sustain--through financial bailouts if needed--state firms specifically under their direction. They also seek state support for those they view as symbols of military and national prestige or as bulwarks of national security--such as the heavily indebted Engesa, the country's largest arms producer. However, military officers, especially service chiefs such as Army Minister Leonidas, have also backed Finance Minister Nobrega's efforts to trim the federal deficit and control inflation, in hopes of avoiding social unrest. The military, though continuing to seek a balance between its needs to protect national security and ensure social order, is likely to remain fully behind maintaining most parastatals, with which it is intimately associated. []

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Labor

Organized labor, long a docile element, has flexed its muscles in recent years in ways that also hamper privatization. The new constitution, which greatly expands labor's prerogatives--especially the right to strike--has contributed to this trend. Late last year, unions representing public sector employees challenged Brasilia's authority to eliminate automatic inflation-adjusted wage hikes, and, according to press, won in the Supreme Court. Now such employees--buoyed by the new constitution's ban on firing of public workers with five years on the job--are fighting to keep such benefits as subsidized

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housing, which probably would cease under private ownership. Accordingly, labor has organized some rallies, including one last August in which over 5000 workers specifically protested privatization plans. Workers at the state-owned Tubarao steel-slab mill--targeted for divestiture this year--struck for increased wages and guaranteed positions under private management. To win greater acceptance for privatization, the government is already offering compensation to affected employees. For instance, the press reports that in some cases it offers severance pay equal to four years' salary and allocates 10 percent of an auctioned company's shares to employees. In addition, Brasilia is studying employee stock ownership plans for some state companies. [REDACTED]

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The Business Community

The business community, where support for privatization logically should be strong, is sharply divided. Most business groups, such as the prestigious Industrialists' Federation of Sao Paulo, persistently urge Brasilia to pare back those enterprises that compete unfairly with private firms and drain Brazil's financial resources. Some individual businessmen, however, fight privatization to protect their special interests. Many private companies have long been dependent on contracts with state enterprises and are reluctant to see that relationship changed. For instance, according to press reports, six private companies have tried to persuade Brasilia to suspend the sale of Caraiba Metals, the country's largest copper smelter, which has cost the government \$19 million. Government officials assert that these firms had "privileged relations" with the smelter's directors and did not want to risk losing their supply of subsidized copper. [REDACTED]

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Other elements of the business community that favor privatization in principle are unwilling to buy many of the state-owned firms that are offered for sale. The vast majority of parastatals Brasilia wants to drop carry burdensome debts or operate at a loss. For instance, Brasilia last year tried to sell a railroad car manufacturing firm that was operating at only 30 percent capacity, but offers did not reach the \$12 million minimum bid set. According to press, the government hopes to auction shares of the firm this year, aiming to divest it piecemeal. The short term financial costs of modernizing and improving the efficiency of these enterprises to make them attractive to investors are too high at a time when Brasilia is trying to reduce government expenditures. We expect that officials overseeing parastatal sales increasingly will have to break up companies for partial sell-offs, accept long-term leasing agreements, or arrange other innovative divestiture formulas to appeal to reluctant buyers. [REDACTED]

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Outlook and Implications for The United States

We doubt that Brasilia will make significant progress towards privatizing--or making profitable--the troubled state-owned enterprises during the remaining year of President Sarney's term. With the presidential elections approaching in November, all eyes will focus on that event and on more immediate issues--particularly inflation and the foreign debt. Indeed, Sarney is likely to conclude that in order to boost the chances of his favored candidate, he will have to spend vast additional public sums for porkbarrel projects--including some through state enterprises. Moreover, even if Sarney chooses to move forward on privatization, his government--already weak politically--is likely to be even more hamstrung in this and other areas. The new, more open political environment is leading to increased assertiveness by all camps, adding more layers of difficulty to an already bogged-down process. In particular, Congress, with its numerous new oversight responsibilities, will be more aggressive. [REDACTED]

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In addition, populism and nationalism are reemerging forces that could strengthen, rather than dilute, government economic intervention generally. This was apparent in numerous aspects of the drafting of the new constitution and is reflected in such measures as a constitutionally mandated interest rate cap on bank deposits and strong measures to limit or prevent foreign investment in some areas. In this environment, some of the presidential hopefuls are playing up the need to "protect" the economy by keeping the government heavily involved, including through state enterprises. One candidate went so far as to advocate nationalizing banks and another has said he favors nationalizing all transportation, education, and healthcare. [REDACTED]

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Nor is Sarney likely to make much headway in increasing the efficiency of the state firms. Even the least controversial methods for limiting Brasilia's state enterprises expenditures--hiring freezes, voluntary early retirement plans, and the like--have failed to do more than simply hold down expansion. Moreover, rapidly accelerating inflation is likely to overtake price increases on public sector goods and services, returning some marginally profitable operations to the red. [REDACTED]

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Over the next year we expect that Brasilia will auction off some of the parastatals it has publicly targeted for privatization--a few steel mills and several small, formerly private-sector companies. Since these are not the largest moneylosers, however, jettisoning them will probably generate only minimal savings, particularly in the near term as Brasilia has to finance their restructuring and debt bailouts prior to sale. [REDACTED]

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Heavily indebted and money-losing state enterprises will continue to be a significant drain on the country's resources and to pose a major challenge for the next administration. Continued preferential treatment for such firms--through easy credit and fiscal incentives--will crowd out private sector firm and discourage the savings and investment needed to boost economic growth and promote modernization. Moreover, parastatals' deficits will tend to hamper control of monetary policy and widen the overall public sector deficit, both of which push inflation higher. Decreasing economic vitality will complicate Brazil's attempts to consolidate its democratic institutions. [REDACTED]

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The state-run white elephants are likely, at least indirectly, to mar Brazil's commercial relations with the United States--economically the single most important country to Brazil--and other countries. For instance, forfeited savings could contribute to continued tensions between Brasilia and its international creditors. The increasing parastatal drain will hamper Brasilia's ability to service its foreign debt--24 percent of which is owed to US banks--and thereby increase pressure on the banks to lend involuntarily. In addition, policies favoring public sector companies will limit commercial opportunities for the United States, which is Brazil's single largest trade partner. Brasilia's subsidies through direct transfers, favorable interest rates, easy access to government funds, or indirect support through tax breaks on imports for parastatals may continue to draw complaints. In the past, these practices have been especially irksome to the United States and could lead to renewed frictions over market access. For instance, US steelmakers have complained that such actions unfairly support Brazil's steel industry--80 percent of which is state-owned--and as a result are likely to lobby for continued restraints on steel imports. The public companies' ability to conduct operations without full public accounting and their disproportionate influence on Brasilia to impose high taxes or markups on competing imports also restrict trade and could add to US concerns. [REDACTED]

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The state-owned enterprises also will probably deter badly needed foreign investment, thereby reducing competition, efficiency, and technology transfer. For instance, Brasilia's granting of monopoly rights to some parastatals is likely to continue to block foreign investment in key industries such as computer technology, making domestic firms dependent on less efficient enterprises for development. Moreover, Brasilia's rules limiting outsiders to minority ownership with little decisionmaking authority will send US firms--Brazil's largest source of foreign investment--and other potential investors elsewhere. [REDACTED]

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